FEDERAL TAX LEGISLATION AND THE STOCK OPTION

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AND
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INTRODUCTION

There is at present, considerable discussion concerning the nature and merits of stock option plans as supplemental means of compensation. One need only open a recent issue of Business Week, Fortune, Duns Review, or any other business oriented publication to realize that the stock option and other forms of executive compensation are of vital interest to the business community. This study is therefore an attempt to evaluate the stock option as an attractive compensation device in light of, and as affected by, federal tax legislation during the past 20 years. The research question to be answered is: How has federal tax legislation influenced corporate and executive interest in stock options during the period 1950-1970?

Five subsidiary questions, keyed to Chapters I through IV are as follows:

1. What are stock options? What are their objectives, and how do they fit into the executive compensation package? (Chapter I).

2. What effect did federal tax legislation have on the development of stock options during the 1950's and mid-1960's? (Chapter I).

3. How great has been the impact of the 1969 Tax Reform Act on stock option plan desirability for the individual executive and for the corporation? (Chapter II).

4. How has tax legislation affected the entrepreneurial incentive value of stock options? (Chapter III).

5. What new stock option practices or related programs have emerged in 1970 as a result of the 1969 Tax Reform Act? (Chapter IV).

Why discuss stock options today? The use of stock options in the corporate compensation package has received wide publicity following enactment of the 1969 Tax Reform Act. Various provisions of the Act have a marked effect upon the present and future attractiveness of the stock option. "It is very possible that those in vogue today will be passe in five years."[1]

By far, the greatest amount of material for this research paper has been drawn from periodicals. Very few recent books have been published on the subject of executive compensation, let alone stock options. This is probably attributed to the changing nature of executive compensation, which may tend to discourage professional contributions utilizing this medium. By contrast, business periodicals keep the public and executives informed regarding the latest trends and developments in executive compensation.

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[1]Ephraim P. Smith, "Happenings in Executive Compensation," Personnel Journal (May, 1970), p. 386.

CHAPTER I

THE STOCK OPTION AS PART OF THE EXECUTIVE COMPENSATION PACKAGE

The heavy progressive personal tax rates which have been imposed in this country since World War II have encouraged corporations to seek out compensation arrangements for their executives which either qualify for capital gains tax treatment or which defer tax liabilities until the lower-marginal-bracket retirement years. In the 1950's and 1960's, stock options were a particular form of reward in this connection.

Perhaps no incentive has come under sharper scrutiny in recent years than the stock option. Any discussion of stock options is necessarily complicated by the variety of stock ownership programs available for use within companies. Statutory and nonstatutory stock options plans have been used with varying degrees of effectiveness to meet compensation and ownership objectives as defined or implied by management.

Effectiveness varies for many reasons. Some programs have been installed without giving much consideration to the objectives the plan hopes to achieve. "A large Midwestern manufacturer, for example, installed a qualified stock option

plan on top of a stock funded profit plan and a bonus plan where part of the reward was deferred stock. The implied purpose of the option plan was to promote ownership of stock among key employees . . . an objective that the other two plans had already achieved."[1]

Stock Option defined

In essence, a stock option represents a corporation's offer to sell a specific number of shares of its stock to an executive at a stated price so long as he completes the purchase within a given period. It is a form of contingent deferred compensation--contingent because its value depends on what happens to the price of the stock during that period; deferred because the tax law imposes certain restrictions as to the timing of exercise and the realization of any gains therefrom. If the value of the stock decreases during the period, he need not buy, hence losing nothing.[2] Since the value of such a plan lies in the future and is somewhat speculative, its worth as pure compensation or immediate reward cannot be readily determined, nor can it be related to current performance. This, however, is incidental, for in many instances the primary purpose of stock options is to spur future

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[1]Richard E. Wettling, "An Up-to-Date Look at Stock Options and Their Use," Compensating Executive Worth, edited by Russell F. Moore, American Management Association (New York, Vail Ballou Press, Inc., 1968), p. 127.

[2]*Ibid.*, p. 127.

performance rather than reward past deeds.[3]

Management of Texas Instruments, Incorporated echoes this purpose. "Although an individual's past performance inevitably presents a basis for determining his probable marked influence on TI's future performance, options are used as an incentive for future individual performance and are never used as a reward for past accomplishments."[4]

The stock option may be said to serve a variety of other purposes.[5]

1. It helps a company create adequate executive incentives and rewards. Today's tax rates, living costs and expenses incident to executive office render it difficult, if not impossible, for managers to accumulate a large estate from savings out of current compensation.

2. In making it possible for an employee to acquire a substantial stock interest, the stock option serves an objective long sought by shareholders; giving management an identity of interest with stockholders.

3. The stock option involves no corporate expenditures of funds, and in fact, brings new funds into the business.

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[3]John R. Hyde, "The Total Management Compensation Package," Compensating Executive Worth, edited by Russell F. Moore, American Management Association (New York, Vail Ballou Press, Inc., 1968), p. 245

[4]P. E. Haggerty, "Incentives in Texas Instruments, Inc.," Incentives for Executives, edited by David W. Ewing and Dan H. Fenn, Jr. (New York, McGraw-Hill Book Company, Inc., 1962), p. 156.

[5]V. Henry Rothschild, "Financing Stock Purchases by Executives," Harvard Business Review (March-April, 1957), p. 41.

4. It provides a method for the smaller company, the growth company, the company with leverage stock, and the company unable to offer substantial cash rewards to compete for executive talent with large established business.

Stock options are not without risk to the executive, however, as market conditions of the past few years will attest. For in accepting them, he is gambling that he will profit more on the stock than by taking straight salary. Working for him in this expectation is the privilege, inherent in the deferred nature of the transaction, of having some of the income taxed as a capital gain, an especially important consideration for executives in the upper income brackets.

For the corporation, stock option programs offer the attractive opportunity to provide substantial levels of compensation without a direct outflow of corporate funds,[6] especially when authorized but unissued stock is used. Certain newer companies with limited capital but good potential have even been able to attract entrepreneurial-minded executives from larger firms. A classical example occurred some years ago when a computer firm (Honeywell, Incorporated) was set up. With little ready cash, but with sound ideas, the nucleus of managers and specialists which was attracted to the firm succeeded in building a going computer business and

[6]Smith, Personnel Journal, pp. 386-391.

in using its stock option program to make themselves independently wealthy.[7] Such programs also have the advantage that the option can be awarded to employees under conditions named by the corporation. Qualified stock options, for example, obliging the executive to hold the stock three to five years in order to obtain a capital gain, tie him to the company.

Stock options, in contrast to most other incentive programs, are designed to give executives a stake in the growth potential of the stock, and, as a special committee found in reviewing the General Motors option plan, thereby stimulate them to maximize their contribution to the long-term success of the organization.[8] In some instances, it must be admitted, corporate earnings may increase substantially without resulting in any corresponding rise in the market value of the stock. And in times of a declining stock market, of course, options lose much of their incentive or attraction value. Nevertheless, in 1969, 394 of the "Fortune 500" companies offered their executives a stock option program.[9]

Findings in large firms

With some exceptions, larger options are granted to

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[7]Wettling, Compensating Executive Worth, p. 129.

[8]*Ibid*., p. 128.

[9]Smith, Personnel Journal, p. 390.

those who occupy the upper rungs of a company's organizational ladder. In addition to having a more direct effect on the company's long term success, these executives usually have more income with which to exercise their options. In a recent study by the American Management Association's Executive Compensation Service of the relationship between total purchase price of options held by 200 top-ranking executives and their annual total compensation, the number of years' compensation represented by the purchase price was as follows:

Number of Years' Compensation	Percentage of Executives
Less than 1	11
1 but less than 2	28
2 but less than 3	23
3 but less than 5	19
5 but less than 10	13
10 but less than 15	4
15 but less than 20	2[10]

Thus it would appear that for top executives, an option grant with a value equal to one to five times their annual compensation is not unusual.

> Since 1950, the restricted stock option has become a popular method of compensating the corporate executive. While stock options and stock purchase plans have been in existence since the early part of the century, they

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[10]Wettling, _Compensating Executive Worth_, p. 143.

were not widely used until changes in the Federal Income Tax Law made possible increased benefits from such plans.[11] Before 1950, the employee exercising stock options was taxed at ordinary income rates on the difference between the market price and the option price on the date of exercise. "This tax treatment afforded options little added attraction compared to salaries paid in cash."[12]

The tax law of 1950 liberalized the treatment of stock options and made them much more attractive as a means of compensation. Under this law, no taxable income is realized by the employee until the time of exercise of a restricted stock option. Income results only if the stock is later sold at a higher price. The attractiveness was further enhanced by the provision that if the stock thus acquired is held for a specific length of time, any gain resulting from the sale is subject to capital gains tax only. The popularity of such compensation plans is evidenced by the fact that, "while only 13.7 percent of the firms surveyed in 1950 by the American Institute of Certified Public Accountants, for its Accounting Trends and Techniques, utilized such plans, this percentage had increased to 75 percent in 1962."[13]

To determine the prevalence of the stock option plan, a base year of 1965 was selected for analysis, since by 1965,

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[11] George C. Holdren, "Stock Options and Management Efficiency," Financial Executive (June, 1957), p. 58.

[12] Ibid., p. 59.

[13] Ibid., p. 65.

not only were companies utilizing restricted stock options, but the qualified stock options brought about by the 1964 Tax Reform Act were also in use. In a report issued by the National Industrial Conference Board, Incorporated[14] of the 1965 compensation of the three highest paid executives in each of 1,304 corporations, a fairly detailed picture of the level of stock option use in six major sectors of our private economy was disclosed.

1. Manufacturing. Almost three fourths (559) of the manufacturers with securities on the New York Stock Exchange had a stock option plan in 1965. These options were somewhat more common among the largest companies, as shown below.[15]

Company Sales	Percent of Companies with Stock Options
$150 million and over	82%
$50 - $149 million	73%
$25 - $49 million	66%
Under $25 million	57%
Total	74%

2. Retail Trade. Almost three out of four (44) retail firms listed on the New York Stock Exchange had a stock option plan. Only 57 percent of the companies with sales under $100

[14]Harland Fox, "Top Executive Compensation," 1966 National Industrial Conference Board, Inc., Personnel Policy Study No. 204, pp. 3-72.

[15]Ibid., pp. 14-15.

million had a plan compared with 80 percent of the larger retailers.[16]

3. Gas and Electric Utilities. Almost one quarter (27) of the utilities had a stock option plan. Only 16 percent of the companies with operating revenue of $100 million or more had a plan compared with 31 percent of the utilities with operating revenue under $100 million.[17]

4. Commercial Banking. Almost one quarter (40) of the banks had a stock option plan. Forty-five percent of the banks with deposits of $1 billion or more had a plan, compared with 36 percent of the banks with deposits of $500-$999 millicn and 10 percent with deposits under $500 million.[18]

5. Life Insurance. Twenty-eight percent (31) of the stock companies had a stock option plan (none of the mutuals, cf course). Like utilities, but unlike the majority of most businesses, these plans were more common in smaller companies than larger companies. For example, 43 percent of the companies with premium income under $10 million had a plan, compared with 24 percent of the companies with premium income of $10-$49 million and 15 percent of companies with $50 million or more income.[19]

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[16] Ibid., p. 53.

[17] Ibid., p. 57.

[18] Ibid., p. 61.

[19] Ibid., p. 66.

6. Fire, Marine, and Casualty Insurance. Thirty percent (11) of the stock companies had an option plan (and none of the mutuals). Eight of the 10 companies with premium income of $200 million or more had a plan, compared with three of the 47 companies with less premium income.[20]

Arch Patton said in 1966,

> The loud wails that accompanied Congress's 1964 changes in ground rules governing options would have led one to believe that this device had lost all its attraction. The facts indicate otherwise. The 505 companies surveyed reported 340 option plans in 1965, versus 351 a year earlier, a dip of barely 3%. This means that the number of companies with such plans slipped from 69% of the total in 1964 to 67% last year--hardly a drop that indicates a devastating loss of confidence.
>
> More importantly, perhaps, new option plans filed with the New York Stock Exchange increased nearly one-third; from 107 in 1964 to 140 in 1965. When amended plans were added to new plans, corporate actions on stock options in 1965 topped those of 1964 by a thumping 44 percent.[21]

Gains from Stock Options

One of the more interesting sets of statistics on gains from stock options is developed by Sibson and Company in their Annual Compensation Survey. In 1970, this survey included a detailed analysis of the paper profit made through exercise of stock options by the top three executives in 150 companies from 1965 through 1969.[22] See Exhibit I.

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[20] Ibid., pp. 71-72.

[21] Arch Patton, "Top Executive Pay: New Facts and Figures," Harvard Business Review (September-October, 1966), p. 97.

[22] Robert E. Sibson, "Executive Pay: A Time of Dramatic Change," Nation's Business (November, 1970), pp. 92-96.

EXHIBIT I

GAINS FROM STOCK OPTIONS

Executives' Annual Salary/Bonuses	Company's Annual Growth Rate		
1965 - 1969 (000)	Low (5% Growth) (000)	Medium (5-12% Growth) (000)	High (Over 12% Growth) (000)
$250	$380	$490	$730
230	350	460	695
210	315	430	660
190	280	400	630
170	250	370	595
150	215	340	560
130	180	305	530
110	145	275	495
90	110	240	460
70	80	210	425
50	45	180	395

Aside from establishing a norm for capital income compensation in this period, the survey spotlights the influence of both company growth rate and company size on capital income compensation. During the years of bullish stock prices (1965 - 1969), price earnings multiples of rapidly growing companies tended to be higher than those of their more stable counterparts.

Thus, stock prices, and stock option gains, were driven up much more rapidly in the faster growing companies.

Furthermore, the top executives in smaller, rapid growth companies have tended to have almost artificially low salaries and bonuses, but large option grants. These companies require highly capable executives but many cannot afford high cash compensation.

Options and federal legislation

Stock option plans appeared in federal legislation with the Revenue Act of 1950, which defined a class of restricted stock options. The Revenue Act of 1954 stipulated that plans meeting certain requirements, concerning such items as timing and limitation of amounts held, could enable an executive to report as a capital gain the difference between the option price and the fair market value at the time when he sold his stock. The Act did not permit any tax deduction by the company on the transaction.

The Tax Reform Act of 1964, which defined a new qualified class of stock options, substantially tightened the requirements: the option price must be at least the fair market value of the stock on the date of grant, not 95 percent of it; the option must be exercised within five years, not ten, if at all; to qualify for capital gains tax treatment, the participant must hold his stock at least three

years, not two; this requirement has severely hampered the average executive's efforts to finance his purchase through normal bank channels.[23] Since then, nonstatutory plans, meaning those which do not meet the specifications of the Internal Revenue Code, including bargain stock plans, options to independent contractors, and options to employees by stockholders, have become more popular. Although they lack some tax advantages of statutory plans, the time when the taxation will occur--the time of exercise or some future time--can be controlled by the terms of the plan, and at that time, the company is entitled to a tax deduction.

Option plans have not been without opposition. Douglas Dillon, speaking as the Secretary of the Treasury during hearings before the Senate Finance Committee, said of the stock option: "We think that it is a wrong system, and we think, basically, it has no place . . . in our tax laws."[24] Other critics have been equally forceful. The AFL-CIO has charged, "They have left a trail marked by special privilege, hypocrisy, tax avoidance, inflationary pressure and stock market abuse."[25] Also numbered among the opponents we find

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[23]Wettling, Compensating Executive Worth, p. 132.

[24]Statement of the Secretary of the Treasury Douglas Dillon, Hearing Before Senate Committee on Finance, Part 1, 87th Congress, 1st Session (Washington Government Printing Office, 1962), p. 459.

[25]The Stock Option Scandal, Industrial Union Department, AFL-CIO (Washington, D.C., 1959), p. 4.

such diverse citizens as Thomas Watson, Jr., of International Business Machines, Nelson A. Rockefeller, Governor of New York, Senator Albert M. Gore of Tennessee, and Dean Irwin N. Griswold of the Harvard Law School.[26] Basically, these critics felt that a stock option provides an executive with a free stock market ride without any risk. If the stock goes up in price, the executive, upon purchasing his option, will have a bargain purchase. As bargain purchases from an employer are normally considered income-taxable at normal rates, these critics declared, the logical question is why options receive preferential tax treatment.

Options have also been challenged on the basis of their excessive cost to the company. On the day a statutory option is exercised by the executive, the company could sell the stock in the open market for its fair market value. The cost to the company is therefore the spread between the price of the stock on the date of grant and its fair market value on the date of exercise for which the company has received no tax deduction.

On the other hand, Henry Ford, II, has credited stock options with being "one of the most efficient and effective methods for rewarding the corporate executive . . . one manifestly fair to all parties concerned."[27] The Congress of

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[26]Daniel M. Holland and Wilbur G. Lewellen, "Probing the Record of Stock Options," Harvard Business Review (March-April, 1962), p. 54.

[27]Henry Ford, II, "Stock Options are in the Public Interest," Harvard Business Review (July-August, 1961), p. 45.

the United States has also given recognition to the need for a law that would provide incentive under high income taxes for those who are willing to risk either their capital or their management reputations and careers. The Senate Finance Committee, in approving the capital-gains provision of the Internal Revenue Code, defined the stock option purpose in these words:

> Employee stock options are frequently used as incentive devices by corporations who wish to attract new management, to convert their officers into partners by giving them a stake in the business, to retain the services of executives who might otherwise leave or to give to their employees generally a more direct interest in the success of the corporation.[28]

Critics, however, contend that even though condoned by the Congress, the stock option is morally wrong for any or all of the following reasons:

1. It is discriminatory and inequitable in application.
2. It is structured and administered by the few who derive the benefit.
3. It does not serve the intended purpose.[29]

In a number of instances, shareholders have attacked compensation by stock option as unreasonable. They have been almost uniformly unsuccessful. The courts may agree with the plaintiff-shareholder that an increase in the market price of the stock from the date of grant to the date when the option price is exercised is not indicative of the value of an

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[28] Thomas M. Ware, "The Value of Stock Options," _Incentives for Executives_, edited by David W. Ewing and Dan H. Fenn, Jr., (New York, McGraw-Hill Book Company, Inc., 1962), p. 98.

[29] _Ibid._, p. 99.

executive's services. However, they are not willing to measure the amount of compensation by the after-grant increase in the stock's market value. Rather, the judicial attitude seems to be that if the option arrangement is reasonable when adopted, the fact that, in hindsight, it may seem generous, is irrelevant. The stock option appears now to be accepted, and generally, beyond serious challenge from a legal point of view if the law of the state of incorporation concerning issuance of options is carefully followed.[30]

Restricted versus qualified options

The 1954 Revenue Act established a set of conditions which must be met if an option is to be classified as restricted. The major requirements may be summarized as follows:

1. The option price must be at least 85 percent of the fair market value of the stock on the day of grant.

2. By its terms, the option cannot be exercised after ten years from the date of grant.

3. With the exception of a special 110 percent pricing rule, no options can be granted to an executive who owns more than 10 percent of the total voting power or value of the corporation.

4. The option, by its terms, is exercisable only by

[30]Walter S. Rothschild, "Legal Problems of Executive Compensation," Compensating Executive Worth, edited by Russell F. Moore, American Management Association, Inc. (New York, Vail Ballou Press, Inc., 1968), pp. 195-196.

the employee or, in the event of his death, by his beneficiaries or estate.[31]

With certain exceptions, according to Section 421 of the 1954 Act, if the recipient of a restricted stock option does not sell the stock for two years after the date of exercise, he will receive preferential tax treatment. Any profit he realizes on the transaction above the fair market value of the stock on the date of grant will be taxed as a capital gain.

The 1964 Tax Reform Act created two new categories of stock option plans to replace the restricted stock option, "which has been the basic framework for stock options granted to top executives and other key employees since 1950. One of the new stock option types was the qualified stock option which applies if a company grants options only to key employees."[32]

Here follow the key factors which must be taken into consideration in structuring a qualified stock option plan to meet the requirements of the 1964 Tax Reform Act.

1. The plan requires stockholder approval. Although stockholder approval was not a requirement for options prior

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[31]Wettling, Compensating Executive Worth, pp. 130-131.

[32]The other type is the employee stock purchase plan which the company would use if it were willing to grant options to essentially all employees. See "Employee Stock Purchase Plans," The Conference Board Record (September, 1966), p. 23.

to 1964, most companies did present their plans to stockholders. In this instance, the 1964 Tax Reform Act merely formalized existing practice.

2. Options must be granted within ten years. Options to purchase shares authorized under the plan must be granted within ten years from the date when the plan is adopted or the date when it is approved by the stockholders, whichever occurs first.

3. Options must be exercised within five years. This restriction, combined with the requirement that options must be granted within 10 years, places a maximum life on any one option program of 15 years.

4. The holder of the option must be an employee. This restriction prevents the use of qualified stock options as a device to compensate independent contractors.

5. The amount of stock already held is limited. Generally, no stock option can be granted to an executive if he possesses more than five percent of the total combined voting power of all classes of stock issued by the corporation.

6. Shares must be held for three years. Under the 1964 amendments, the holder of the option must not sell or transfer his shares for a three-year period beginning the day after the date of transfer following his exercising the option.

7. Old options must be exercised first. This requirement precludes the possibility of an executive's

exercising only his newer options in the event the per-share value of his company's stock has fallen and he has older, higher-prices options still outstanding.

The qualified stock option is different in many respects from the restricted stock option, but the two most important differences are these: (1) Under the qualified plan, the executive must hold the stock at least three years in order to get the full capital gains; under the restricted stock option plan, he had to hold the stock only six months after the purchase and only two years after the grant of the option; (2) Under the qualified plan, an executive has only five years after the date of grant to exercise an option: under the restricted stock option, he had ten years.[33]

The 1964 Tax Reform Act had the effect of "freezing" the further use of restricted stock options and substituting qualified options and stock purchase plans in their place.

Nonstatutory options

During the 1950's, restricted stock option plans came into their own, and by the early 1960's approximately two-thirds of all listed corporations had some sort of stock option program. In the mid-1960's, the additional restrictions imposed on statutory options by the 1964 Tax Reform Act focused attention by many companies and consultants on

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[33]Harland Fox, 1966 National Industrial Conference Board, Inc., p. 6.

nonstatutory stock option programs.[34]

A nonstatutory option includes any type of compensation which fails to meet the requirements of a qualified plan. As an example, a nonstatutory plan can be structured so that the option period can extend beyond five years, the stock is offered at less than its fair market value, or the three year holding period need not apply.

Although nonstatutory option plans offer a company considerably more flexibility in plan design, they do present a different series of tax considerations and problems. Depending on how a plan is structured, the participant will generally incur an income tax liability as compensation received either at the time of the option grant, in the year when he exercises the option, or sometime in the future. The company will receive a corresponding deduction. However, after this tax has been paid, the basis of the shares will be adjusted, and any further gain in an arm's length sale or transfer will be taxed as capital gains.

The recent interest in nonstatutory stock options has centered around plans in which the options do not have a readily ascertainable fair market value at the time of grant. Plans of this kind can be structured to provide an effective estate-building program, a partly tax sheltered form of compensation, or a combination of both. Through restrictions

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[34]Wettling, Compensating Executive Worth, pp. 130-131.

imposed on the participant, taxation of the options as compensation can be controlled to occur at the time they are exercised or sometime in the future.

Summary

Stock options are a form of supplemental compensation which came into wide use in corporate executive pay packages following passage of the 1950 Revenue Act. The stock option became a very popular incentive for the executive primarily because of the favorable tax advantages it afforded. It is designed as a long-term incentive and is normally offered to executives in high decision-making positions in the enterprise. An option grant of five times annual salary is not unusual. Executive gains from stock options have been very impressive, particularly in the faster growing industries.

The stock option also provided an attractive opportunity for the corporation to offer executives substantial levels of compensation without a direct outflow of corporate funds. As a result, although stock option programs are found in most major corporations, they are primarily found in the larger, high-revenue companies of the manufacturing and retail-trade industries.

The first legal recognition of options was given to the restricted stock option by the 1950 Revenue Act. Further requirements were imposed by the 1954 Revenue Act. The

qualified stock option was an outgrowth of the 1964 Tax Reform Act, and this option virtually replaced the restricted stock option as a prime motivator within most large corporations.

Option plans have had considerable opposition, particularly in the 1950's and early 1960's, mainly for their having preferential tax treatment and for the excessive costs experienced by the companies in administering the stock option program. Much criticism results from shareholders and public officials, who claim this form of compensation is unreasonable, discriminatory and inequitable in application. However, Congress has taken a very definite stand in support of the stock option by asserting that the top executive in the organization who is willing to risk capital, reputation and career, is entitled to some form of tax relief; the tax advantages on stock options in the 1950's and early 1960's afforded this relief.

CHAPTER II

STOCK OPTIONS AND THE 1969 TAX REFORM ACT

Provisions of the Act

Much of the problem of the appeal of a stock option plan evolves from the Tax Reform Act of 1969 which has reduced the attractiveness of both the restricted stock option and the qualified stock option.

> The Tax Reform Act is turning out to be a nightmare for both executives and for the companies they manage. It deals some devastating blows to certain forms of compensation that have been widely credited with attracting and motivating executives.[1]

In the year since the Act was passed by Congress, many companies have been altering their management compensation plans to avoid the brunt of these blows. There is no question that executives, particularly those in the highest levels, will be hurt by the new tax rules, and there is no telling what effect the changes in the tax law will have on the quality of business leadership.

Shortly after the passage of the act, considerable enthusiasm was expressed regarding the "corporate executive's tax law. This misguided enthusiasm was excusable, since the act is very large and quite complicated and the full implications

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[1]Arthur M. Louis, "Hidden Jokers in the New Tax Deck," Fortune (July, 1970), p. 100.

of its many provisions could not be grasped at once."[2] Now, one year later, the Tax Reform Act seems destined to provoke a major revolution in executive compensation.

Changes that affect stock options

Because this thesis is devoted to stock option analysis, it seems appropriate to discuss the impact that changes resulting from this tax law will have on a typical corporate executive who occupies a top management position where part of his compensation is in the form of stock options.

Earned income.--The most common form of managerial earned income is cash salary, paid during or shortly after the year in which it is earned. There are several other types of executive compensation that are also considered earned income. For example: (1) cash or stock bonuses, if they are paid within a year after they are earned; in the case of stock, the tax would be assessed on the market value at the time the executives took possession; (2) cash or stock paid in installments over a period of years, if each payment occurs within a year after the executives' right to it is no longer subject to a substantial risk or forfeiture; (3) cash or stock bonuses that become vested within a year before being distributed in a lump sum.

The earned income maximum can save a highly paid executive considerable money, in taxes compared to previous tax

[2]*Ibid.*, p. 100.

regulations provided his return isn't cluttered with a lot of tax preference income as well. Suppose, for example, Executive Jones reports taxable income of $150,000 on a joint return and that he has no other income. During 1970, he would be in the 66 percent tax bracket, and his total tax bill would amount to $76,980. In 1971, the maximum rate on earned income is scheduled to decline to 60 percent. Since part of the executive's income, the top 50 percent to be exact, had previously been taxed at more than 60 percent, he would pay a lower tax in 1971; the tax on that top $50,000 would drop from $31,800 under the old law to a flat 60 percent or $30,000, during 1971, for a savings of $1,800. In 1972, when the 50 percent maximum rate is supposed to take effect, the top $98,000 of Executive Jones's income, previously taxed at more than 50 percent, would be subject to reduced rates: the levy on the top $98,000 would decline from $58,920 to $49,000. <u>This would bring the tax bill down to $67,060, or $9,920 less than he paid under the old law.</u>

<u>Tax preference items</u>.--The tax preference provision of the new act imposes a ten percent penalty tax on certain favored forms of income. Congress set up a double exclusion, to spare both those taxpayers who have only modest amounts of tax preference income, and those who pay substantial taxes despite their tax preference income. In determining how much of his tax preference

income is subject to the penalty tax, an individual is entitled to exclude the sum of $30,000 plus the amount that his income tax would be if there were no tax preference items.

Tax preference items are of considerable concern to the participants in a stock option program, particularly where qualified stock options are concerned. The difference between the exercise price and the market value of a qualified stock at the time it is purchased is considered a tax preference item, and so is one-half of any net long-term capital gain. To illustrate, suppose the same Executive Jones decides, during 1972, to exercise an option to buy 13,000 shares of his company's stock at a price of $15 per share, at a time when the share has a market value of $25. The $130,000 difference between the total purchase price and the market value of the stock would be considered tax preference income. After allowing for the $30,000 exclusion, plus an exclusion equal to his $67,060 in regular taxes, he would still have to pay a penalty tax on $32,294. The outcome would be similar if, instead of exercising stock options that year, he were to sell previously acquired stock at a fat capital gain.

But the tax picture for Executive Jones is not complete, since tax preference income can offset the amount of earned income subject to the new maximum rate. The taxpayer is allowed an exclusion here too, but it is limited to a flat $30,000. Even after this exclusion, Executive Jones still

would be required to reduce by $100,000 the amount of his earned income qualifying for the 50 percent maximum. However, only $98,000 of his earned income was subject to tax rates exceeding 50 percent under the old law. The $100,000 in tax preference income remaining after exclusions would be more than enough to offset the $98,000; thus the tax preference income would push Executive Jones's tax back up to $76,980 from $67,060 precisely where it stood under the old law. By merely exercising his stock option, he would have incurred $13,214 in additional taxes, including the penalty tax ($76,980 - $67,060 + the 10 percent penalty tax of $3,294). Additionally, there is no guarantee that the stock will appreciate.

Capital Gains.--The Tax Reform Act of 1969 has increased capital gains taxes for the highly paid executive. Under the old tax law, only half of net long-term capital gains was taxable, and the maximum levy on this portion was 50 percent; or to put it another way, the total net gain was subject to a maximum rate of 25 percent. Now, only the first $50,000 of long-term net capital gains qualifies for the 25 percent maximum. Anything beyond that will be taxed up to 29 1/2 percent in 1970, up to 32 1/2 percent in 1971, and up to 35 percent starting in 1972. With straight salary scheduled to be taxed at a maximum of 50 percent, plus the penalty tax of

10 percent, many executives may find the advantages of capital gains too small to make the extra risks worthwhile. Under a qualified stock option plan, for example, the stock must be held for three years after exercise to qualify for capital gains treatment; in the meantime, the stock could plunge.

Returning to Executive Jones with $150,000 of taxable earned income; suppose his only other income consists of $300,000 in net long-term capital gains. Prior to the 1969 Tax Reform Act, his tax on earned income was $76,980, while his tax on capital gains would have been at the old maximum rate of 25 percent, or $75,000; his total tax bill would have come to $151,980.

After the Act became law, the computation becomes much more complicated and the tax rises sharply. As previously shown, the top $98,000 of Executive Jones's earned income would come under the 50 percent maximum starting in 1972, causing his tax on earned income to decline to $67,060. However, since there is capital gains income, one half of it is treated as a tax preference item. Even after allowing for the $30,000 exclusion, this would be more than enough to eliminate any benefit Executive Jones might have received from the earned income maximum. His tax on the earned income would come to $76,980, which is where it would have stood under the old law. In addition, after allowing for an exclusion of $97,060 (ie., $30,000 + $67,060 in tax that would have been

paid if there were no tax preference income), there remains $52,940 subject to the ten percent penalty tax; the penalty tax increased the tax bill by $5,294.

Finally, Executive Jones has to determine the tax remaining on his capital gains. The first $50,000 of capital gains would be taxed at the old maximum rate of 25 percent so the payment on this portion would be $12,500. The $250,000, which is the difference between the stated capital gains of $300,000 and the $50,000 subject to the 25 percent rate, would be taxed at rates up to 35 percent, and thus the total tax on $300,000 would be $87,500.

Therefore, after all computations are taken into consideration, it is possible to determine the total tax, based on the given assumptions for Executive Jones. The total tax bill which considers payments on earned income, the penalty tax, and the capital gains tax, would amount to $181,974, which is $29,994 more than Executive Jones would have paid under the old law.[3]

The above analysis conclusively proves a point; the top executive in American industry finds himself in a less favorable tax position as a result of the 1969 Tax Reform Act than he formerly was. A comparison with other forms of compensation is presented later in this Chapter. The total

[3]This author is very grateful for the assistance rendered by Walter T. Windle, tax consultant to the Goodall Rubber Company, in helping to analyze the provisions of the 1969 Tax Reform Act and for verifying the correctness of the tax calculations for "Executive Jones."

compensation received by Executive Jones is not unrealistic in today's economy. The firm of Sibson and Company developed, in 1970, a management compensation study which covered salaries of chief executive officers in 650 industrial companies which reflected the reasonableness of the figures utilized to compute Executive Jones's taxes.[4]

The figures take on added significance when they become large enough to reduce the earned income sheltered by the 50 percent maximum tax, thus showing more of that in the 1970, 70 percent tax bracket. What happens is that the higher the paper gain from exercising stock options, the bigger the tax bill on salary and bonuses. "Robert Sibson tells of one chief executive who, as the result of merely exercising options, faced a total tax equal to 104 percent of his normal salary and bonus."[5]

Perhaps the most confusing aspect of the 1969 Tax Reform Act is that for the first time each of the elements affects the other. It is impossible to analyze the elements of executive compensation one at a time as was formerly possible.

The Act and restricted options

Most aspects of the stock option program have been treated thus far from the standpoint of the 1969 Tax Reform

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[4]Robert E. Sibson, "Executive Pay: A Time of Dramatic Change," Nation's Business (November, 1970), p. 90.

[5]Louis, Fortune, p. 80.

Act with the exception of one: the restricted stock option.

The main element of a restricted stock plan is an agreement by the employer corporation to either sell at a substantial discount or to give outright a specified number of shares of the common stock of the firm to certain of its employees.[6] In the absence of any restriction on the employee's right to resell the shares, the difference between their market value at the time of the transaction and the price, if any, paid for them would be taxed immediately as ordinary income.

> Since restrictions are placed on resale, however--for example, the recipient may be prohibited from disposing of the stock for a period of five years on penalty of having to return the shares to his employer--and since tax administrative practices hold that such constraints preclude effective realization of the value of the securities by their nominal owner, no federal income tax is levied until the restrictions lapse.[7]

At that point, the employee is assessed a personal tax, and the corporation is permitted a corresponding deduction from its own income.

Holders of restricted stock options, under the new law, will find themselves in a terrific quandary. They must decide within 30 days after the stock is transferred whether they will pay a tax at once, based on the market value at

[6] George W. Hettenhouse and Wilbur G. Lewellen, "The Taxation of Restricted Stock Compensation Plans," National Tax Journal, Vol. XXII, No. 3 (September, 1969), p. 368.

[7] V. H. Rothschild and J. B. Salwen, "The Restricted Stock Plan Arrangement: A Practical Analysis of its Current Use," Journal of Taxation (June, 1968), p. 239.

the time they got the stock, or whether they will wait until the restrictions lapse and pay a tax based on the market value at that time. While the maximum tax rate on earned income will apply to restricted stock, this benefit is more than offset by the fundamental change in the way the stock is taxed. If the executive is optimistic about the company's prospects, he has to assume that the stock will rise in value by the time the restrictions lapse; were that the only consideration, he would almost certainly decide to pay his tax at the time he received the stock. However, if he pays the tax at that time, and later forfeits the stock, his payment will not be refunded. And even if the executive does not forfeit, he would be outsmarted if he decided to pay the tax at the outset and the stock then proceeded to decline in value; by waiting until the end of the restriction period, he would have been subject to a smaller tax payment. All of which sounds like a good argument for waiting until restrictions lapse before paying the tax--except that by then, the stock may have skyrocketed leaving the executive with an extra large tax bill.[8]

If the executive gets full rights to the restricted stock and later sells it, he will be taxed at capital gains rates on the difference between the selling price and the market value at the time he chose to be taxed. This is

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[8] Louis, Fortune, p. 111.

similar to the tax treatment under the old law, which had executives paying capital-gains taxes on the difference between the selling price and the value that was taxed initially.

"It appears that the restricted stock option will be the chief casualty of the act . . . in the next year or two, almost all . . . restricted stock option plans will vanish."[9]

Thus, it can be said that corporate advisors have a new goal; that of shifting compensation into the more advantageous "earned income" category and minimizing top executive tax preference items.

The Act and investment interest

There is another provision in the Act which also affects the executive who is partially compensated by stock options and that provision covers investment interest. Virtually all executives who exercise stock options borrow part of the money which they sink into the investment. Interest paid to finance a stock purchase traditionally has been deductible in full on an individual's tax return. But, in 1972, the Tax Reform Act limits the amount of the investment interest that may be deducted in calculating one's tax bill. In the meantime, investment interest will be treated as tax preference items subject to the 10 percent penalty tax and may also have to be offset against the amount of the earned income qualifying for

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[9] Ibid., p. 100.

the maximum tax rate. Starting in 1972, investment interest will no longer be considered a tax preference.

This provision is not of interest to the average investor, but to the top executive with large holdings, it is a very important factor. For example, in a joint return the flat sum of $25,000 in investment interest continues to be deductible; the figure is $12,500 for separate returns. This means that if an executive is paying 8 1/2 percent interest annually on an investment debt as large as $294,117, he can automatically continue to deduct the full amount of interest (8 1/2 percent of $294,117 equals $25,000). In addition, he can deduct an amount of investment interest equal to the sum of his net investment income (such as dividends) and his net long-term capital gains. Finally, if the executive's investment interest exceeds the sum of $25,000 plus the net investment income plus the net long-term capital gains, he still can deduct an amount equal to one half the excess.

"By establishing a direct relationship between dividends and deductions, Congress was trying to encourage investments that provide immediate income . . . and therefore immediate tax revenues."[10]

A cost-benefit analysis

Drawing on the provisions of the 1969 Tax Reform Act,

this writer has developed a cost-benefit analysis for various types of executive compensation elements. The intent was to ultimately rank the different stock options in relation to other elements of the pay package.[11]

In analyzing the present situation, the following general conclusion has been reached: stock options are quite inefficient in a monetary sense. Although they received favorable tax treatment under the old law of marginal tax rates, stock options are inferior to current cash compensation in all but the very highest income classes. The Tax Reform Act provides lower marginal tax rates on earned income, and this reduction has decreased the efficiency of stock options in the pay package.

To simplify this discussion, attention is directed to the comparative cost of rewarding several "typical" executives in a "typical" large corporation. What is a "typical" executive? Usually the age and income level are the most important determinants of the cost structure. Considered here will be a 50 year old executive in four income classes; $20,000, $50,000, $100,000, and $150,000. The consolidated assumptions in four executive profiles, one for each income class, are shown in Exhibit II. The typical executive has currently taxable income from investments or previously

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[11]A similar analysis was developed by George Hettenhouse and Wilbur G. Lewellen which reflected taxation prior to the 1969 Tax Reform Act. See Wilbur G. Lewellen and George W. Hettenhouse, "Taxation of Compensation," The Journal of Taxation (September, 1969), pp. 168-171.

EXHIBIT II

ECONOMIC PROFILES OF "TYPICAL" EXECUTIVES

IN FOUR INCOME CLASSES

INCOME AND TAXES	INCOME CLASS			
	$20,000	$50,000	$100,000	$150,000
Current Before-Tax Salary and Bonus	$20,000	$50,000	$100,000	$150,000
Additional Current Taxable Income	5,000	12,500	25,000	37,500
Total Current Taxable Income	$25,000	$62,500	$125,000	$187,500
Years Service at Retirement	40	40	40	40
Expected Annual Pension Benefit	$ 8,000	$20,000	$ 40,000	$ 60,000
Anticipated Gross Estate	$250,000	$625,000	$1,250,000	$1,875,000
Current Marginal Tax Rates:				
a. On Ordinary Income	28%	53%	61%	68%
b. On Earned Income (1971)	28%	53%	60%	50%
c. On Earned Income (After 1971)	28%	50%	50%	50%
Current Capital-Gains Rates:				
a. On First $50,000 in Gains	14%	25%	25%	25%
b. On Gains in Excess of $50,000	14%	26.5%	31%	34%

EXHIBIT II--Continued

INCOME AND TAXES	INCOME CLASS			
	$20,000	$50,000	$100,000	$150,000
Tax on Preference Items	10%	10%	10%	10%
Retirement Marginal Tax Rate	22%	36%	53%	58%
Retirement Capital-Gains Rates:				
a. On First $50,000 in Gains	14%	18%	25%	25%
b. On Gains in Excess of $50,000	14%	18%	26.5%	29%
Marginal Tax Rate Applicable to Beneficiary	20%	32%	50%	55%
After-Tax Opportunity Rates:				
a. Low Risk	4%	4%	4%	4%
b. Moderate Risk	6%	6%	6%	6%
c. Investment Risk	9%	9%	9%	9%

deferred income (or both) that amounts to 25 percent of his current compensation income. Additionally, the typical executive generates tax deductions and exemptions comparable to other men in his income class.[12] At retirement age of 65, the executive has earned a pension equal to 40 percent of his career-average salary. At death, he leaves a gross estate equal to ten times his total pre-tax annual income, which is then taxed accordingly. Finally, it is assumed that he considers deferred benefits (pension plans and stock options) as relatively low-risk sources of income. Stock options introduce the most uncertainty into the current valuation of the pay package, and consequently, have been discounted at a rate appropriate for an equity investment.

A "typical" company applies to the larger, publicly-owned company that is listed on one of the major stock exchanges. It is assumed that the company makes a profit each year and is taxed at the marginal rate of 48 percent.

What is the value of the reward an executive receives from a particular compensation device? In calculation of the reward, two steps were followed. First, the elements of a pay plan that accrue to an executive as a direct result of his employment were determined. For example, the value of a stock option is limited to its potential for purchasing stock at a price under the then-current market price. Dividends and

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[12]Internal Revenue Service statistics of income data for married taxpayers filing joint returns, 1969.

price appreciation realized by the executive after exercise of the option, on the other hand, are available to any investor purchasing a like number of shares on the exercise date and hence do not count as compensation to an executive. Second, all the different elements were put on a comparable basis. In other words, the differences resulting from dissimilar tax treatment and time of receipt were accounted for by recasting all quantities in terms of their after-tax present values.

Once the reward was determined, the cost was easy to find.

> The costs include items that are not identified as costs in the accounting sense. For example, options and bargain sales of stock are not accounted for as deductible compensation; but realistically speaking, such transactions nonetheless represent a company cost, since they dilute the collective wealth of the company's owners.[13]

Once all such elements of the cost were determined, they were placed on a comparable basis by computing their after-tax present values to the corporation.

To summarize, then, the procedure boils down to finding the after-tax, present value cost to the company of providing a given after-tax, present value benefit to the executive. By repeating this procedure for each element of pay, one can identify both the relative costs of providing a given reward and the relative rewards possible for a given cost.

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[13]Lewellen and Hettenhouse, The Journal of Taxation, p. 169.

By way of illustration, suppose that an executive who is currently 55 years old is granted a deferred pay contract that provides for a lump sum payment of $1,000 in the year following his retirement at 65. The contract also provides that in the event of his death, this payment will be made to his beneficiary on the date originally stipulated. The executive is likely to be in a 30 percent marginal tax bracket after retirement and his beneficiary is likely to be taxed at a 25 percent marginal rate. Mortality tables show that the probability of a 55-year-old male surviving for 10 years is roughly .86.[14] The net after-tax payment, therefore, will amount to $700 if paid to the executive and $750 if paid to his beneficiary. The expected payment considering both possibilities is $\$700(.86) + \$750(.14) = \$707$. Assuming that the executive has an after-tax opportunity cost of five percent per annum, the after-tax present value of this pay contract at 55 is $\$707/(1.05)^{10}$, or $434.03. So much for the reward.

From the company's point of view, it must pay $1000 in 10 years regardless of what happens to the executive. Since it can then deduct this payment against corporate income, the after-tax value of the asset it is transferring to the executive is only $520 (assuming the 48 percent tax rate). The cost, then, is the present value of this asset;

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[14]This writer is indebted to Mr. I. Lee Atkinson, District Manager, Southwestern General Life Insurance Company, Alexandria, Virginia for providing the appropriate mortality tables.

assuming an annual 10 percent opportunity cost, it is $\$520/(1.10)^{10}$, or roughly \$200.46. On a per dollar basis, this cost is roughly \$0.46 for each dollar realized by the executive, that is, \$200.46/\$434.03 = \$0.46.

By applying the analytical procedure, described above, for each type of pay alternative, the alternative costs are illustrated in Exhibit III. Each figure in this exhibit represents the after-tax, present value cost the company incurs to provide each grade of executive with an additional after-tax award of \$1.00. For example, it costs the company \$0.72 to provide an additional dollar in salary and bonus to an executive aged 50 who earns \$20,000 per year. Alternatively, the company could provide the additional dollar by increasing his pension benefits--this would cost \$0.536--or by granting him a qualified stock option which would cost \$1.071. The pay plans have been ranked by relative cost efficiency; thus one can identify the plan that entails the lowest cost per dollar of reward by identifying the plan with the highest rank within the income class.

In the \$20,000 class, "Current Salary and Bonus" ranks ten, which means that there are nine less costly means of providing an equivalent reward. The conclusion, then, at least for this executive, is that current cash renumeration is a relatively undesirable vehicle for compensation. If compensation decisions were made strictly on the basis of

EXHIBIT III

COMPARISON OF AFTER-TAX MARGINAL COSTS PER DOLLAR
OF BENEFIT REALIZED BY AN EXECUTIVE AGED 50
IN EACH OF FOUR INCOME CLASSES

COMPENSATION MODE	$20,000		$50,000		$100,000		$150,000	
	COST	RANK	COST	RANK	COST	RANK	COST	RANK
Current Salary and Bonus	$0.722	10	$1.040	11	$1.040	10	$1.040	10
Group Life Insurance								
a. Coverage Less than $50,000	0.921	12	0.982	10	0.982	9	0.982	8
b. Coverage More than $50,000	1.323	14	3.971	14	3.971	14	3.971	14
Deferred Bonus (5 Year Stream)	0.614	7	0.877	6	0.877	5	0.877	5
Deferred Pay Contracts:								
a. Single Payment at Retirement	0.302	3	0.356	2	0.443	3	0.477	3
b. 10 Payments at Retirement	0.269	2	0.311	1	0.370	1	0.391	1
Qualified Pension Plan	0.536	5	0.648	4	0.883	6	0.987	9

EXHIBIT III.--Continued

COMPENSATION MODE	$20,000		$50,000		$100,000		$150,000	
	COST	RANK	COST	RANK	COST	RANK	COST	RANK
Qualified Profit Sharing Plans:								
a. Single Payment in 5 Years	0.597	6	0.846	5	0.851	4	0.853	4
b. Lump Sum in Retirement	0.346	4	0.382	3	0.437	2	0.446	2
Qualified Stock Option	1.071	12	1.179	13	1.179	12	1.179	12
Nonqualified Stock Options:								
a. Exercised in Year 5	0.688	9	0.981	9	0.981	8	0.981	7
b. Exercised in Year 10	0.655	8	0.917	8	0.917	7	0.917	6
Restricted Stock Plans:								
a. Currently Taxed	0.722	10	1.040	11	1.040	10	1.040	10
b. Taxed when Restrictions Lapse	0.256	1	0.911	7	1.636	13	2.162	13

the economics of the transaction, current salary and bonus would be used quite infrequently. This, of course, is clearly not the case in practice. The tradition of salary and bonus rewards and, more importantly, the employee's need for some basic level of income on a current, liquid basis explains the predominance of this type of reward in existing pay packages.[15] The whole purpose, of course, in deriving the statistics in Exhibit III was to ascertain, through a cost-benefit procedure, the attractiveness of the stock options to both the executive and the corporation as a result of the 1969 Tax Reform Act. There seems to be little question that the qualified and restricted stock options are not a very efficient form of compensation as far as cost to the company or benefit to the executive are concerned.

The drastic change in the taxation of restricted stock options has produced a rather curious result. As noted in Exhibit III, restricted stock plans, that are taxed when restrictions lapse, have a highly unstable cost performance across income levels, jumping from first to nearly last in the cost rankings. The low cost of these plans for low-income executives results from the fact that price appreciation in restricted shares is now taxed as compensation to the executive and hence is a deductible expense for the company.

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[15]George W. Hettenhouse and Wilbur G. Lewellen, "The Taxation of Restricted Stock Compensation Plans," National Tax Journal (September, 1969), p. 367.

So long as the employee's marginal tax rate is less than the 48 percent corporate tax rate, each dollar in price appreciation in the restricted shares tends to further reduce the per dollar cost of reward.[16]

Additionally, the cost figures suggest that more companies will resort to bonuses and nonqualified stock options in the future for rewarding top executives.

Summary

There were many revisions to management compensation plans in 1970, and most of the revisions had an important impact on corporate stock option programs. The major event which triggered this activity was the 1969 Tax Reform Act. While the 1964 Tax Reform Act reduced the attractiveness of the restricted stock option, the 1969 Act put the finishing touches on the restricted stock option and dramatically reduces the attractiveness of the qualified option, at least to the highly paid executive.

From the individual executive's standpoint, new tax provisions which apply to earned income, tax-preference income, and capital gains have had a decided impact on the interest the executive has placed, and will continue to place, on the attractiveness of the stock option. Generally speaking, for the executive with earned income in the upper brackets, with stock options and considerable long-term

[16] Ibid., p. 368.

capital gains, there is no question that, as a result of the 1969 Tax Reform Act, he will be paying much higher taxes than he would have under the old tax laws. The "Executive Jones" illustration conclusively proved this point.

The Act virtually "killed off" the restricted stock option. Under the provisions of the Act, the executive must decide, within 30 days, whether to pay taxes on the market value of the stock at the time the option was exercised or at the time the restrictions lapse. This is a very difficult decision, and one which few executives care to make, since no one knows whether the stock will appreciate or decline by the time the restrictions lapse. If the stock appreciates, it is to the executive's benefit to pay the taxes now. If the stock should decrease in market value, it would, of course, be to the executive's benefit to pay the tax at the time the restrictions lapse.

Stock options, as a result of the 1969 Tax Reform Act, are quite inefficient as a monetary compensation device. The executive and corporate management can readily see, based on developed alternative costs, that stock options rank very low in relative cost efficiency when compared with other elements of compensation. This ranking is the result of a cost-benefit analysis--finding the after-tax, present value cost to the company of providing a given after-tax, present value benefit to the executive.

CHAPTER III

THE STOCK OPTION AS AN ENTREPRENEURIAL INCENTIVE

No one is likely to suggest that the U. S. Congress would deliberately set about to eliminate one of the most powerful entrepreneurial incentives ever created: the stock option. Yet, by passing the Tax Reform Acts of 1964 and 1969, Congress substantially reduced the profit potential of options and thus, in effect, crippled what has claimed to be one of the principal motors of industrial growth in this country. Possibly Congress reacted primarily to management's abuse of stock options in the years immediately following the legalization of restricted stock options in 1950. Had they taken the time to consider the effectiveness in historical perspective, their action might have been different.[1]

> Although the effects of these tax laws are now beginning to become evident, the stock option's loss of power as a long-term incentive does not appear to be widely recognized . . . a fact backed up by the number of companies that renewed old stock option plans in the opening months of 1970 as though nothing important had happened.[2]

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[1]Erwin N. Griswold, "Are Stock Options Getting Out of Hand?" Harvard Business Review (November-December, 1960), p. 55.

[2]"Managers Beyond the Fringe," Economist (February 21, 1970), p. 69.

Contribution to Growth

While there is certainly room for debate as to whether or not the widespread use of stock options contributed to the expansion of U. S. industry after 1950, the fact remains that industry did expand prodigiously over the last two decades. In the three years prior to the passage of stock option legislation (a period, incidentally, of post-war recovery, not of recession), the gross national product rose an average of 3.3 percent annually. Each three-year period since 1950, except for the recession period around 1958, has surpassed the pre-option level.[3] Furthermore, the rate of gain has increased with the passage of time, perhaps because time improved both the administration of options and management's recognition of their incentive value.

> As companies became increasingly sophisticated in using options, the entrepreneurial incentive value of this compensation device increased. Indeed, it appears that Congress undercut stock options just as the usage of this complicated incentive tool was reaching full flower.[4]

Obviously, not every recipient of a stock option grant immediately becomes a zealous entrepreneur, making ever-increasing profits for his employer. It could be that few executives are sufficiently motivated by options to significantly change the profit fortunes of their respective

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[3]Paul A. Samuelson, Economics (New York, McGraw-Hill Book Company, Inc., 1967), p. 184

[4]J. E. Wilson, "Let's Integrate Executive Compensation," Personnel Journal (August, 1970), p. 673.

companies. However, these few may have added significantly to the expansion of industry by providing the leadership for less motivated executives.

A practical affirmation of the stock option's contribution to the nation's economy is presented by a group of companies located near Boston.

> Those familiar with the development of this microcosm along the 'miracle miles' of Route 128 are convinced that the incentive which made executive staffing of these new companies possible was the stock option, for salaries were deliberately kept low to minimize costs. Perhaps coincidentally, the electronics and R & D companies started their hegira to the newly constructed Route 128 in 1951, the very year after the restricted stock option was legalized. The executive and research talent required to expand this limited base was attracted by the capital gains lure of restricted stock options. Although it is clear that many of the 800-odd companies strung along Route 128 today were relatively well-established when they arrived, many of the 70,000 employees in this complex came to their jobs because of the availability of stock options at a very critical juncture in their company's history. This includes many executives and researchers who left a big company or university to accept the low starting salary and risks of a fledgling enterprise.[5]

No one, of course, can determine how much our country stands to lose as a result of the new businesses that are not born because of changes wrought in the industrial environment by the Tax Reform Acts. But every major industrial city--Los Angeles, Cleveland, Chicago, to name a few--is surrounded by its equivalent of the Route 128 community.[6]

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[5]"Incentives: Jam Tomorrow," Economist (March 15, 1969), pp. 69-70.

[6]*Ibid*., p. 70.

Destruction of Incentives

In hindsight, it is clear that the 1964 Tax Reform Act, by raising the holding period for capital gains treatment to three years and by reducing the option life span from ten to five years, partially destroyed the stock option as a major incentive. However, no one realized this fact because the "devastating portent of the 1964 tax act was concealed . . . by the continued rise in stock prices during the late 1960's. This perhaps helps to explain the generally myopic view of stock options prevailing long after its passage."[7]

Senior executives, who had profited handsomely from their earlier options, felt it only fair, when old plans expired, to offer the new qualified options to oncoming younger executives. The latter, in turn, accepted the options in good faith because of the earlier profitability to their seniors.[8]

In 1969, just when the five-year option period of early qualified plans was expiring and options had to be exercised, the stock market slumped badly. The full disaster brought about by the 1964 Tax Reform Act was exposed by this collapse. Executives who had purchased optioned shares with funds borrowed at upward of nine percent or ten percent

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[7] Ibid., p. 70.

[8] R. E. Sibson and R. A. Sbarra, "Pricing Together the Compensation Puzzle," Business Management (January, 1969), p. 35.

interest suddenly found it necessary to sell-out to protect their loans. To illustrate: One senior executive exercised a 3,000 share option in late 1968, when his company's shares were selling at $110. Since his option price was $52, he borrowed approximately $156,000 to buy the stock. His protective margin of "paper" profit by this time was $174,000. By early fall of 1969, however, the stock price had slumped to $63 and his margin of safety had fallen to $33,000. He then faced the agonizing decision of whether to sell or hold. By selling he would protect his loan but lose a capital gains opportunity and a certain amount of "face" with his fellow officers. Fortunately, he did sell, and made a modest profit, on which he paid an ordinary income tax, for the stock has since dropped below $50.[9]

It has been estimated that perhaps half of all executives who exercised options in the late 1960's were forced by declining prices to sell their stock in self protection. Many more hold options priced substantially above today's market, and the first-in-first-out provision of the 1964 Act has them trapped. In other words, they cannot exercise a later, lower priced option until they have exercised the earlier, higher priced one. Thus, even before the 1969 Tax Reform Act, the incentive value of options was seriously compromised, at least among executives who were recipients

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[9] _Ibid._, p. 37.

of the qualified options permitted by the 1964 law.[10]

Further Fetters

The 1969 Tax Reform Act actually did not deal directly with stock options. However, the entrepreneurial incentive value of options was indirectly undermined by two aspects of the new act:

> (a) the increase in the tax on capital gains, whereby only the first $50,000 of gains is now eligible for the 25 percent alternative tax.
> (b) the provision which stipulates that one element in the executive's compensation package must be evaluated in terms of its impact on another element of his total pay.[11]

This latter is something new in this kind of legislation. It provides that an individual's earned income (that part of his income eligible for the new 50 percent maximum tax) may be affected by the tax preference income he reports, which includes stock option gains at date of exercise plus one-half of all capital gains. This tax preference income may also be subject to a new "minimum tax" of ten percent. Thus, the Tax Act's impact on stock option gains requires an assessment of provisions involving the minimum tax, the maximum tax, and the alternative tax on capital gains.

This new interdependence of one element on another in the total compensation package tends to confuse each element's individual incentive value. For example, discounting capital

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[10]Arch Patton, "Thinking Ahead," Harvard Business Review (September-October, 1970), p. 25.

[11]Arch Patton, "Executive Compensation Inequities," Business Horizons (April, 1970), p. 76.

gains on stock options by 25 percent no longer gives the executive an accurate measure of his profit, since complex tax considerations have now been injected where none existed before. In such a situation, the short-term incentive, representing the "bird-in-hand," tends to erode the value of the longer-term incentive.

The 1969 Tax Reform Act also gave short-term incentives another big boost by establishing the 50 percent maximum individual tax rate starting in 1972. "When fully operative, this provision will be equivalent to a $10,000 raise for the executive with $150,000 in net taxable income."[12] The spendable income yielded by this change in the maximum tax rate has the effect of downgrading all kinds of deferred income, including capital gains that may result from stock option profits in the future.

Increasing Disillusion

The net effect of the last two tax acts and the stock market slump in 1969 and 1970, is a severe reduction in the incentive value of options. The more sophisticated executive has become aware that the three-year holding period of the 1964 Act and the constraints of the 1969 Act, make capital gains profits from options less attractive. Consider the following case as offered by Arch Patton:

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[12]"Executive Pay to Climb Faster in Next Five Years," Industrial Week (May 11, 1970), p. 24.

> The president of a consumer goods company recently went shopping for two highly entrepreneurial top executives. He was in an unusually good position to attract men of this temperament, for he had founded his own company and built it to annual sales of nearly $100 million in less than a decade. Further, he was the dominant stockholder and willing to pay whatever it took to get the right men.
>
> The two candidates he settled on were senior executives in competitor companies with sales in excess of $1 billion. Both men received cash compensation of more than $100,000, well above what the same jobs in the president's relatively small company were valued at in the marketplace. But he felt that these men would be worth any reasonable premium, and agreed to meet their cash income needs. The two candidates also had sizable stock options in their companies, and here the president believed he had a big advantage. Their very large companies were growing at industry's 6% rate, while his company was surging ahead at better than 35% compounded . . . and probably would continue this growth rate for several more years.
>
> Despite a stock option offer worth more than $1 million for each future doubling of the company's stock price, both men decided against accepting the job offer. Indeed, the president agreed to <u>double</u> the size of these already generous options when he sensed this reluctance to join his company . . . without success. These apparently highly motivated men simply did not believe that stock options would pay off for them, even if the stock price doubled or trebled. Capital gains potential of stock options, the classical entrepreneurial incentive of recent years, did not provide adequate motivation for these two executives to change jobs.[13]

Not all executives, however, have become disillusioned with stock options. The younger executive, particularly one who has not had an option, still finds them attractive. But his interest primarily reflects his lack of experience with and knowledge of the changes which have resulted from the

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[13] Arch Patton, "Thinking Ahead," <u>Harvard Business Review</u>, p. 27.

1964 and 1969 Tax Reform Acts. Furthermore, the younger, middle-management executive typically regards stock options as a secondary incentive. His primary interest is current income.[14] Thus it is fair to say that the option has not lost its secondary value as an incentive, just its primary entrepreneurial value.

Only the very highly paid top executives make the important entrepreneurial decisions, and options have been an important motivator to those executives where stock option plans were in effect. But now, it appears, as a result of the 1964 and 1969 Tax Reform Acts, that industry must build its executive incentive program around short-term company profits. "The one truly long-term profit incentive was the stock option,"[15] and the message from Congress on this entrepreneurial incentive comes through loud and clear to all but the youngest executives.

The implications of the short-term profit focus of executive incentives are ominous for the individual company and for the economy as a whole. Based on this writer's knowledge of incentives, it is his belief that individual incentives must directly reflect the corporate interest. Yet when incentives are keyed almost exclusively to short-term profits, it becomes relatively easy for executive

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[14]H. Spencer, "How Share Incentive Schemes are Working Out," Director (June, 1970), pp. 457-459.

[15]*Ibid.*, p. 458.

interests and corporate interests to differ. Corporate concern with building tomorrow's profits tends to increase current costs and to reduce today's profits. Since executive incentives are now largely based on current profits, there is reduced motivation to build for the future. For example:

Suppose a company is having a good year, but the following year is expected to be a poor one. It is not difficult under such conditions to add profit to the current year by shifting costs to the following year. This would have the effect of permitting bonus increases in year one without reducing compensation in year two, when no bonuses would be paid anyhow. In other words, executive interests would differ from corporate interests, and the short-term reward focus would offer management an incentive to make decisions that are detrimental to the company.

Rationale for Change

It is strongly suspected by this writer, that unless Congress reinstates some form of entrepreneurial incentive, with a focus on the long-term profitability of enterprise, the 1970's are likely to go down in history as a dismal decade in terms of the growth rate. Some might take issue with this view, claiming that the nonqualified option provides adequate motivation for the long term, but despite the

fact that this type of option is offered by any number of companies, it does not fill the entrepreneurial need. Consider: Any profit is treated as current income by the individual recipient, and the cost is a deductible expense to the corporation on exercise. This tends to influence the short-term view. To the extent that individuals sell stock at exercise to pay taxes, the nonqualified option is unlikely to build substantial executive stock ownership in an enterprise.

To date, few, if any, entrepreneurial incentives have even approached the effectiveness of the 1950 restricted stock option as a financial inducement for executives to build long-term company profits. What can be done about this situation? Obviously, it will take legislative concern and action.

Naturally, every nuance of a stock option program cannot be legislated.

> The option is a unique entrepreneurial incentive with a long 'learning curve' as far as effective administration is concerned. And for better or for worse, the skill with which management administers an option plan is a critical factor in its effectiveness.[16]

That cannot be legislated.

The 1969 Tax Reform Act's phased reduction in the maximum rate on earned income will help restore the loss of after-tax income suffered by top management during the past

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[16] Robert V. Sedwick, "Trends in Top Management Compensation," Personnel (American Management Association, July-August, 1968), pp. 48-49.

two decades. (The policy-level executive's share of total corporate payroll, for example, dropped 25 percent between 1945 and 1968 according to a McKinsey and Company survey of 86 large companies.)[17] However, the net effect of the Act's tax treatment represents little more than an "overkill," since the 1964 Act and the subsequent stock market slump have left, it would seem, just an afterglow of the option's previous incentive value.

It is interesting to note that the economic boom of the 1950's and 1960's paralleled the life span of the restricted stock option. If, as this writer strongly suspects, Congress made a mistake in killing off stock options as an effective incentive for building new companies, steps should be taken to rectify this error before the 1970's are too far along. Tax reform has seriously undermined the profit potential of stock options and thus (assuming they are primarily motivated by monetary returns) executives are less likely to work in the long-range interests of their companies.

Summary

By passing the Tax Reform Acts of 1964 and 1969, Congress has reduced profit potential of stock options and therefore may have established obstacles to industrial growth in the United States. The tax provisions of the two Acts may well have had a detrimental effect on top management's

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[17] P. H. Durston, "Uproar Over Options," Duns Review (December, 1969), p. 40.

long-term business outlook. The effect of the 1964 Act was not readily apparent until the stock market began to decline significantly in 1969. The 1964 requirements to hold options for three years and reduce the option life span to five years were important factors in destroying the option's entrepreneurial incentive. These restrictions, coupled with the 1969 Act's increase in tax on capital gains and the provision on evaluating each pay element in terms of its impact on an executive's total pay, created short-term incentives and short-term profitability objectives. Because executive incentives are now largely based on current profits, there could follow less motivation to build for the future.

CHAPTER IV

CREATING A NEW DEMAND

The 1969 Tax Reform Act, a bear market on Wall Street and galloping inflation have thrown corporations into a turmoil over how to pay their top executives, particularly those who are paid above $52,000 per year. "There may not be many of them, but they have a lot of muscle, and companies feel it when they sneeze."[1]

Reform

As consultants, lawyers, and accountants dream up new strategies, virtually every large company has been forced to take a hard look at its compensation program. The results of these reviews are beginning to take shape.

1. Cash and bonuses are becoming more attractive, while deferred compensation plans grow increasingly risky.

2. Corporations are not scrapping stock option plans, but they are supplementing them with such devices as non-qualified options, phantom stock programs, and tandem stock options. Even stock option swapping is taking place in a few companies.

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[1]"A Confusing Payday for Men at the Top," Business Week (October 10, 1970), p. 80.

3. A few consultants are pushing flexible "smorgasborg" or "Cafeteria" compensation packages, which allow executives to choose how they will be paid.

> Nineteen sixty-nine and 1970 have been years of great change in management compensation . . . there have been more revisions of management compensation programs in the past 12 months than any other recent year. About half of the nation's companies have made changes in their stock pay programs.[2]

Not surprisingly, the whole business of options is now coming under careful scrutiny. Already, of course, they have changed a good deal over the years. As discussed previously, up to 1964, the big stock option was the restricted type. When Congress cracked down on restricted options, they were succeeded by qualified options. Today, the qualified option is still popular, but losing its appeal.

<u>The transition periods</u>

The stock option had its heyday in the 1950's and early 1960's when the top personal tax rate was as high as 91 percent. But, when a highly paid executive sold stock he acquired through options, he paid no more than 25 percent on the gain.

In 1964, the top tax was cut to 70 percent, and the rules of the game were also changed. Options had to be exercised within five years rather than ten, as before.

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[2]Robert E. Sibson, "Executive Pay: A Time of Dramatic Change," <u>Nation's Business</u> (November, 1970), p. 89.

More importantly, once options were exercised, the executive was required to hold on to them for three more years to get the lower capital gains tax rate. Previously, the minimum holding period had been six months. The changes made options increasingly difficult and costly to finance.

The 1969 Tax Reform Act really administered the coup de grace to the qualified stock option. Beginning in 1972, earned income such as salary will be taxed at no more than 50 percent, while the capital gains rate on such items as option gains moves up to 35 percent. And, the executive also may have to pay an additional ten percent minimum tax on a portion of extremely large preference income items . . . which include one-half of long-term capital gains as well as any paper gain on the difference between an option's exercise price and the stock's market value.

The experiences of Litton Industries provide a good example of the effect that the stock market can now have on a qualified stock option plan. As recently as early 1967, top executives at Litton Industries were delighted about the 250,000 shares that stockholders had just voted to set aside for them under a qualified option plan. It was not surprising, for by then every share of Litton, even after a 2 for 1 split, was worth $117, and the bull market seemed to be gathering strength. But all did not end well for the

happy executives. The Litton plan called for a waiting period of a year before the options could be granted, which is not an unusual restriction. This brought its executives to the threshold of 1968. Even with the price down from the previous years peak to the 80's, 70's and 60's, no one took the drop for more than an aberration. Considering that shares bought under option must be paid for at the full market price the day the award is granted, the stocks had, in fact, a special new attractiveness.

There was one big problem however: Litton had thoughtfully provided an installment plan to go with its options. Instead of having to dip into reserves or borrow money to buy the stocks with a lump sum payment, Litton executives were allowed to pay for them in equal amounts over a five year period, always, however, at the price of the original grant. By the end of 1970, Litton stock had slid all the way to 15 1/2 per share which is certainly alarming to executives whose options provided a "bargain" price of $66 to $85 a share.[3]

Even with the difficulties experienced by Litton Industries, options are still far from dead; they are just being overhauled to make them more effective in the light of current market and tax conditions. In January, 1971, McKinsey and Company released a new study which sampled

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[3]"The Uproar Over Options," Duns Review (December, 1969), p. 39.

165 large companies in a wide mix of industries. The survey showed that qualified options are definitely losing ground as the most popular means for extra compensation.

> While 65 percent of the companies with option plans were giving qualified options in January, 1970, that figure dropped to 58 percent by year end. But more significantly, when companies get around to the changes they say they are working on, the percentage of qualified option plans could fall to as low as 38 percent in the near future . . . maybe as early as next year.[4]

What is happening is that companies are putting in more flexible, diversified compensation plans such as tandem options and phantom stock. The use of tandem option plans, a combination of both qualified and nonqualified options, more than doubled in 1970 and soon, as Exhibit IV shows, may account for about one-third of the special plans. Similarly, the use of phantom stock, which is essentially a fancy way of giving a deferred bonus, grew by more than 100 percent in 1970 and is expected to double again.

In January, 1971, another new study by Peat, Marwick, Mitchell and Company, using the latest proxies from 676 of the largest companies on the New York Stock Exchange, shows that almost 80 percent have now put in some kind of option plan, versus 74 percent a year ago. The study also confirms that executives were in a hurry to exercise options before the new tax law took effect. Managers exercised options equal

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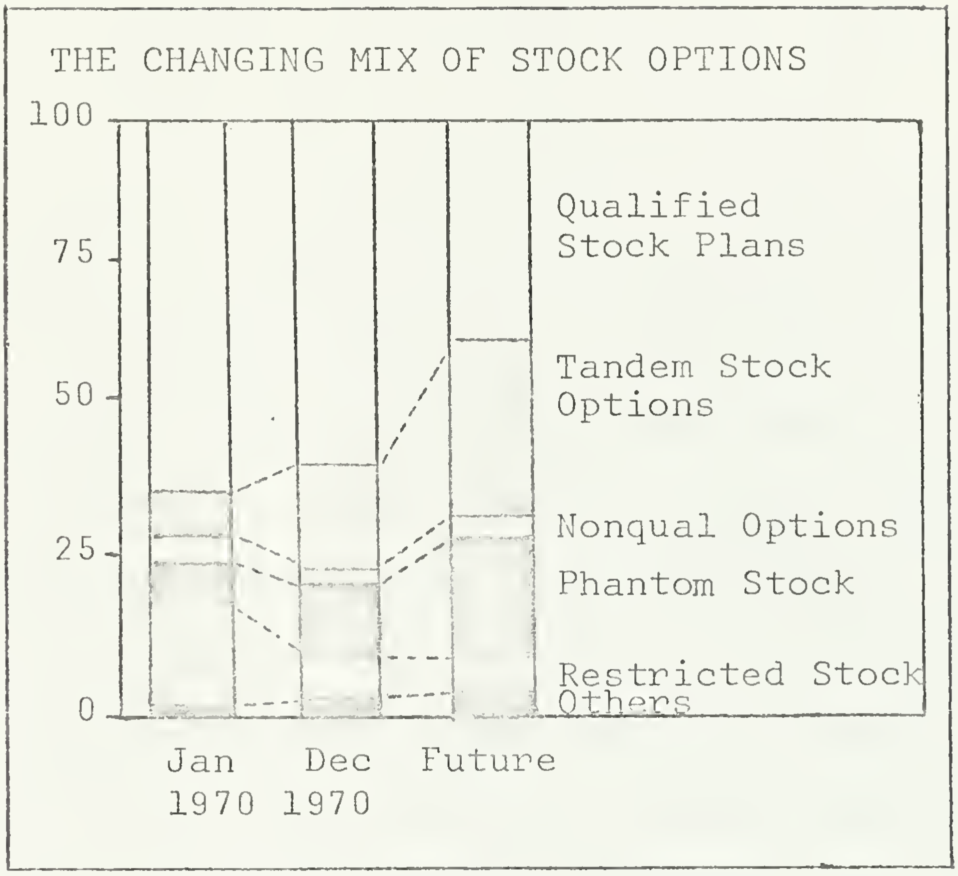
[4]"Top Men Demand New Kinds of Pay," Business Week (January 23, 1971), p. 65.

to 88.6 percent of their direct pay, as compared with only 67.4 percent a year earlier.[5]

EXHIBIT IV



Data: McKinsey and Co.

Demand for new compensation elements

But the main point is that vast new complexities have been introduced since the various compensation items are now interrelated in terms of tax effects. An executive's first reaction, it would seem, is to throw up his hands and to demand "cash now." As a result, some companies hire outside experts to help their executives sort out the problem areas.

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[5] Business Week, p. 66

And other companies are setting up tax-sheltered investments, such as apartment complexes and other real estate ventures, in which they let top management participate.[6]

Nonqualified stock options.--At the heart of the search for new compensation schemes, to combat the provisions of the 1969 Tax Reform Act, is a surge of interest in the nonqualified stock option. It differs from the qualified stock option in that the exercise period is not limited to five years and there is no three-year holding requirement, making it less costly to finance. The nonqualified option can also be issued at less than market price. Any paper gain between the market and the exercise price is taxed at the 50 percent "earned income" maximum upon exercise, while the company gets a deduction for the same amount as a salary expense. Charles Peck, analyst for the American Management Association, said; "A good flexible arrangement, maybe with a provision for installment buying, is what a lot of companies need, and adding the nonqualified option is one way to get it."[7]

Tandem stock plans.--While a few companies have gone to nonqualified options, more interest is in the new tandem plans that combine both qualified and nonqualified options. Tandem options are being used in two ways. Under one scheme, the compensation committee can grant either qualified or nonqualified

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[6] Ibid., p. 67.

[7] Duns Review, p. 40.

options to executives as they see fit. Other plans grant executives both kinds, and let the manager choose which he will exercise. McKinsey and Company contends that tandem plans provide "a hedge against still more tax law changes in the future, as well as flexibility for individual executive needs."[8]

Phantom stock plans. Late in the Spring of 1970, International Telephone and Telegraph (ITT) unwrapped a new compensation package for its executives. In line with the trend, the ITT plan includes both qualified and nonqualified stock options. Of even greater interest though, it offered for the first time, a third incentive that the company carefully labels a "performance stock unit plan." But, by this or any other name, what ITT is actually giving its top executives is one of the most versatile, if least known, of all corporate motivators: phantom stock.[9]

Phantom stock could enjoy a tremendous surge in popularity in the wake of the 1969 Tax Reform Act. Phantom stock does not qualify for capital-gains treatment, which is probably the main reason it has remained obscure. But the new law makes capital-gains income much less appealing than it was under the old law. As the name implies, phantom stock awards do not consist of actual stock. Instead, the company credits

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[8] Business Week, p. 66.

[9] John C. Perham, "Phantom Stock: Better than Options," Duns Review (September, 1970), p. 33.

the executive with a number of stock "units," which rise or fall in value as the company's stock rises or falls in the market. Under some phantom plans the full value of the fictitious stock is eventually distributed to the executive, while under others only the amount of any gain in market value is paid out. Either way, the executive can profit from the performance of his company's stock without risking any of his own capital. The phantom plan also provides an advantage to the company, since any distributions are tax-deductible; qualified options, by contrast, do not provide tax deductions for the company.[10]

Phantom stock plans, though little publicized, are not really new. They have been around for over 15 years, and among the long-time users are du Pont, General Motors, Union Carbide, Koppers, Bethlehem Steel and Eastman Kodak.[11]

In its simplest form, the executive is awarded units equal to a certain number of imaginary shares of company stock and receives every year a sum equal to the dividends on these shares. The payments are usually accumulated in the executive's account until he retires, although a number of the companies pay out the cash each year. Thus, while the market fluctuations of the company's stock can affect the executive's overall compensation, he is assured of a healthy

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[10]Arthur M. Louis, "Hidden Jokers in the New Tax Deck," Fortune (July, 1970), p. 112.

[11]Duns Review, p. 33.

payoff year after year regardless of market performance, just as long as the company keeps paying out dividends.[12] Stockholders tend to be highly critical about stock option awards, not to mention six-figure salaries and bonuses, particularly when they are upset over market losses and falling earnings. But, they are less likely to complain about compensation based on dividends, a benefit they also receive and would themselves like to see get bigger each year.

The cumulative effect of phantom stock can really become impressive. Not only does the executive collect the dividends on his units everytime the company makes a payout, he can also be awarded new units year after year. As units are added to units, and dividend payouts to dividend payouts, the executive's account can build up spectacularly.

The real beauty of phantom plans for the executive is that he is not required to risk a cent of his own money and so never has to worry about financing. Compare this with the plight of the executive with stock options caught in a tight-money, bear-market situation.

Any payments made from the account of the executive are taxable in the year they are received. The executive has the option of deferring payment, and therefore his

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[12] John C. Perham, Duns Review, p. 33.

taxes, for as long as fifteen years, but that would almost certainly make his compensation ineligible for the 50 percent maximum tax rate applied to earned income.

> Indeed, there is some disagreement among tax experts as to what, if any, phantom-stock income can be considered earned income. The Treasury Department has not ruled on this matter.[13]

While considerable space has been devoted to phantom stock plans, this writer feels that this type of plan will, if any plan at all can, replace the stock option as the prime long-term incentive; and this has only come about by federal tax legislation and its impact on stock options. The future of phantom stock plans is, admittedly, uncertain since Congress may decide to tighten up on all forms of deferred compensation. The fact remains, however, that it did pass through the 1969 Tax Reform Act unscathed.

Swapping stock options.--Amid all the turmoil and disappointment that surrounded the bull-market options in the bear market at the close of 1970, and the announcement of the disappointing effects of the 1969 Tax Reform Act on stock options, companies have been trying to figure a way to make options more attractive. New gimmicks have been established and one of the more interesting is the option swap.[14] In essence the company is telling their executives to turn in their useless old options and the company will give them an

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[13] Louis, Fortune, p. 112

[14] "Now They're Swapping Options," Duns Review (October, 1970), p. 45.

equal number of new ones, priced to fit the collapsed market. The idea sounds attractive. The company relieves the participant of his tarnished right to buy stock at bull market prices and awards him a new option adjusted to the bear market. "In this way management hopes to kindle enthusiasm for one of its favorite tools for rewarding executives and keeping them happy in their jobs."[15]

There is a hitch, however, for no company can blithely call in old options just because they appear to be worthless, declare them null and void and replace them. In other words, these new options are not exercisable until such time as the surrendered options would have expired. The Internal Revenue Service considers them still in effect until their scheduled expiration which is five years from the date of issue for qualified options.

The executive who accepts the proposed swap receives a piece of paper that has no value until his options run out. It does provide him with a timely psychological lift, by letting him know that management is attempting, within the framework of the law, to do all they can to make the options worthwhile as a means of compensation.

In one variant or another, announcement of option swaps have recently come from Fairchild Camera and Instrument Corporation; from Gulf Resources and Chemical Corporation;

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[15] Ibid., p. 45.

from the Questor Corporation; and from Sears, Roebuck-controlled De Soto, Incorporated (a maker of paint and coatings).[16] Gulf Resources appears further along in the swapping process than some of the other companies. In their 1970 proxy statement, "A total of 48 optionees surrendered 178,650 options exercisable at an average per share option price of $23.60 for new options covering 178,650 shares exercisable at $9.125 per share."[17]

From management's viewpoint, swapping options does have an advantage since it can take options out of circulation. So, as it grants new options, it can take an equal number out of circulation, thus keeping the total number of shares outstanding within limits approved by the stockholders.

The option swap is better than nothing, but its advantages to the participant are limited. What he really receives is an eventual claim on the stock at today's prices. Thus, he is gambling that over the next few years the stock market will go up. The point comes to mind, however, that this was the same motivation he had when he exercised options originally.

<u>Summary</u>

Stock options are far from dead, but recent tax legislation has caused considerable corporate deliberation on the

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[16] *Ibid.*, p. 45.

[17] J. E. Wilson, "Let's Integrate Executive Compensation," *Personnel Journal* (August, 1970), p. 673.

best way to pay their top executives. Stock option plans are particularly receiving wide attention because most of the provisions of the 1969 Tax Reform Act are considered to be unfavorable to the heavily compensated top executive. Other new elements of compensation are probably receiving equal attention, if not more.

There is little question that stock options are losing their appeal as far as the executive is concerned. If the executive loses interest, then the corporation must do something to assure the recapture of his interest and confidence. How can stock options or closely related compensation elements be made more attractive? Corporations are devising alternative measures which will provide, within the limitations of the law, a motivational impact on the executive. Nonqualified stock option plans, tandem stock option plans, phantom stock plans, and option swapping are some of the remedies. The most appealing appears to be the phantom stock plan, for it offers a higher degree of long-term incentive without any financial risk to the executive.

CHAPTER V

CONCLUSION

Every field of endeavor has its prophets and the field of executive compensation is no exception. This is especially true whenever major tax legislation changes occur. Corporate management and the individual executive certainly do their share of prophesying, and with recent tax legislation changes, the "executive suite" is pondering the alternatives of executive compensation today.

Stock options can be eminently successful and extremely efficient in rewarding the highly compensated executive, provided they are blessed with favorable tax considerations. They can make possible levels of compensation otherwise unattainable under the personal income tax structure. This is not, however, universally true. Stock options in the early 1960's, for example, had advantages for the executive whose annual salary was approximately $75,000. Below that level, where a great number of options existed, it was generally true that a simple increase in salary would have been of greater benefit not only to the executive but also to the company. These findings or conditions were not plausible in the 1970 economy.

The stock option received its official Congressional sanction via the 1950 Revenue Act. This legislation was to have a decided impact on executive compensation for the next twenty years, for it created the restricted stock option, one of the most powerful top executive motivators industry has ever known. The reason for restricted stock option success was that through the 1950 Revenue Act, executives were granted long-term capital gains tax advantages, the result of which, was an almost overnight boom in the use of corporate stock option plans. The 1950 Revenue Act, in effect, liberalized the treatment of stock options and made them much more attractive as a means of compensation. The 1954 Revenue Act further refined the provisions of the 1950 Revenue Act, by providing ground rules for the timing of and limitations for reporting of capital gains.

The restricted stock option flourished during the 1950's and 1960's as evidenced by various surveys conducted by such notable consulting firms as McKinsey and Company and Robert E. Sibson and Company. These firms, along with the National Industrial Conference Board, provided sufficient statistical information to validate the widespread use of the stock option. Approximately two-thirds of all companies listed on the New York Stock Exchange during the 1950's and early 1960's is a good indication of the attractiveness of the stock option. The manufacturing and retail trade industries

utilized the stock option as an executive motivator to the greatest extent. Within industries, regardless of type, most option programs were found in the high annual revenue companies. Stock option gains were particularly impressive, sometimes amounting to five times an executive's annual base salary and bonuses.

It may appear that with the passing of the 1950 Revenue Act that all companies and all executives were proponents of stock option programs, but this was not true. There were many opponents from the private and public sectors who normally based their objections on, what they considered to be, unreasonable tax preferential treatment afforded stock options. Although formal objections were registered in federal courts, they were almost uniformly unsuccessful. Congress maintained its position that there was a need for tax relief for the top executive who was willing to risk capital, career, and reputation for the enterprise. Thus, tax advantages augment the profitability of stock options. Moreover, there would have been no extensive executive interest in corporate adoption of stock plans in the 1950's if there had not been accompanying tax advantages. Tax legislation in 1950 gave stock options their greatest impetus, and in the process, made many an executive a wealthy man.

After 1950, tax legislation had little impact on executive and corporate interest in stock options until the mid-1960'

Nineteen-sixty-four heralded the 1964 Tax Reform Act. This Act had a significant influence on the types of stock options adopted, but not on the prevalence of stock option programs. The 1964 Tax Reform Act took much of the steam out of restricted stock options and provided a framework for structuring the qualified stock option plan. The legislation had the effect of "freezing" the further use of restricted stock options and substituting qualified options in their place.

The main provisions affecting stock options were the requirements that options be exercised in five years in lieu of 10 years (as with the restricted stock option) and shares must be held for three years, (instead of six months) before they could be sold. Although these were not the only provisions, they did have a decided impact on the fall of the restricted stock option. The net result was a complete turn around, with almost three out of four option plans being of the qualified type.

Without a doubt, the 1969 Tax Reform Act has had a greater impact on executive compensation, and particularly stock option plans than any tax legislation since 1950. The effects have been dramatic, not only to the executive, but also to the corporation. It has virtually eliminated the further development of the restricted stock option. The corporation is presently in a real quandary in its attempt to develop a compensation package which will be attractive

to the executive while maintaining the lowest possible costs for each element of the package. The new tax provisions have a decided effect on each element of the compensation package since they specifically apply to earned income, tax-preference income and capital gains.

There is little question that the top executive exercising stock options today finds himself in a less favorable tax position as a result of the 1969 Tax Reform Act. By actual tax calculations for a hypothetical executive (Executive Jones) in Chapter II, under reasonable income circumstances, this point was illustrated. Many executives have found the advantages of capital gains too small to make extra risks worthwhile. While a complete discussion of the provisions of the Act was presented in Chapter II, it is significant to note that beginning in 1972, the capital gains rate will go up to 35 percent for gains of more than $50,000, as opposed to the 25 percent tax on all capital gains under the old law. This increase, plus the provision of reporting paper gains between the option price and the market price as tax-preference income for the three years prior to the top executive's eligibility to sell the stock, make the qualified option a less desirable element in the compensation package.

Through utilization of a cost-benefit procedure, it was possible to rank the various stock options, based on the after-tax, present value cost to the company of providing

a given after-tax, present value benefit to the executive. A visual check of the alternative costs developed in Exhibit III, Chapter II, clearly shows that by using the provisions of the 1969 Tax Reform Act, the qualified and restricted stock options are relatively inefficient in a monetary sense. It would appear that stock options, under the present tax structure, have little right to be included in the compensation package.

Chapter III covered the impact of the 1964 and 1969 Tax Reform Acts on the entrepreneurial incentive value of stock options. There is little doubt that Congressional endorsement of the 1964 and 1969 tax legislation reduced the attractiveness of the stock option and therefore crippled one of the most influential factors in long-range industrial growth. Tax reform has seriously undermined the profit potential of stock options and thus executives are less likely to work in the long-term interests of their companies. How much this country stands to lose as a result of the new enterprises not born can not be determined, but the two Acts have taken their toll.

The effect of the 1964 Tax Reform Act was not readily apparent until 1969, when the stock market plummeted. The Act, by raising the holding period for capital gains to three years and reducing the option life to five years, contributed to the decline of the stock option as a major incentive.

This fact was not generally recognized because the stock market prices rose appreciably during the late 1960's, over-shadowing the deleterious effects of the tax reform. However, in 1969, it became all too clear when many executives had to sell their options to cover high interest payments on loans originally made to buy the options.

Corporations are not scrapping stock options as a result of the 1969 Tax Reform Act, but they are definitely looking to new avenues for executive compensation. The stock options have lost sufficient appeal to the top executive that corporate management must be able to provide suitable, substitute inducements. During 1970, at least four new programs have received wide attention; nonqualified stock options, tandem stock options, phantom stock, and option swapping. While option swapping is not widespread in industry, the other three have gained momentum at the expense of the qualified option. The problem is to develop that formula of executive compensation which will provide the executive with a hedge against the provisions of the 1969 Tax Reform Act.

How has federal tax legislation influenced corporate and executive interest in stock options during the period 1950-1970? The impact of tax legislation on corporate and executive stock option plans during the past 20 years has been extensive. Tax legislation provided the major impetus

for the creation of the restricted stock option in 1950, let restricted option plans flourish for about 13 years and then provisions of the 1964 Tax Reform Act reduced restricted stock option plan desirability for the executive. As a result, corporations shifted to the qualified stock option in order to provide executives with the incentive to meet their own individual needs as well as the entrepreneurial needs of the firm. The qualified stock option remained as a powerful form of supplemental compensation until enactment of the 1969 Tax Reform Act. The provisions of this Act again set corporations to the task of finding new ways to maintain executive interest in stock options, having realized that the executive, by maintaining his present stock option program, was subject to higher taxation than he formerly was. Thus, from 1950 to 1970, the corporation continually sought that entrepreneurial incentive that would stimulate the executive to work in the best interests of the firm, while attempting to develop new stock option programs for the executive which were of greatest personal benefit to him in terms of the effect of tax legislation changes. The search for the right entrepreneurial incentive continues.

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